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No. 82-

In The

Supreme Court of the United States

October Term, 1982

Chemetron Corporation,
Petitioner,

v.

Business Funds, Inc., John F. Austin, Jr., and David C. Bintliff,
Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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QUESTIONS PRESENTED

1. Should there be a denial of *any* private remedy under federal law for proven violations of two separate antimanipulation provisions—§§ 9(a)(2) and 10(b) of the Securities Exchange Act of 1934—because of failure to prove that the plaintiff (Petitioner here) bought or sold "at a price which was affected by" the § 9(a)(2) violation, as required by § 9(e)?

2. As a matter of construction of § 9(e) alone, is there such a failure of proof when the price of a security registered on an exchange is negotiated off the exchange on the basis of "the fundamental value of the company" (A75) but there is a finding that the decision to buy would not have been the same "if all transactions comprising the scheme, plan or conspiracy to manipulate had been disclosed to [the Petitioner] prior to the purchase" (B11)?

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OPINIONS BELOW

The opinion of the Court of Appeals (A1-A111) is reported at 682 F.2d 1149 (5th Cir. 1982). The final judgment of the District Court and the orders in connection with posttrial motions (B1-B28) are not officially reported.

JURISDICTION

The judgment of the Court of Appeals was entered on August 16, 1982. The Petitioner filed a timely petition for rehearing and a suggestion for *en banc* consideration. On September 20, 1982, these were denied (C1). The jurisdiction of this Court is invoked under 28 U. S. C. § 1254 (1).

STATUTES INVOLVED

The text of §§ 9(a), 9(e) and 10(b) of the Securities Exchange Act of 1934 (the "1934 Act"), 15 U.S.C. §§ 78i(a), 78i(e), 78j(b), together with Rule 10b-5, 17 C. F. R. § 240.10b-5, is appended (D1-D4).

Section 9(a) contains certain prohibitions against manipulation of the prices of securities registered on an exchange. Section 9(e) makes any person "who willfully participates in any act or transaction in violation of" § 9(a) "liable to any person who shall purchase or sell any security at a price which was affected by such act or transaction."

Section 10(b) makes it unlawful, in contravention of the Commission's rules, for any person to employ "any manipulative or deceptive device or contrivance" in connection with the purchase or sale of *any* security. And Rule 10b-5 is the rule that implements § 10(b) in general terms.

STATEMENT OF THE CASE

This case arises out of the Western Equities, Inc. ("Westec") "stock scandal" (A1), which resulted in convictions of several of the participants (A69-A73)[1] and substantial losses to the investing public, including the Petitioner, Chemetron Corporation (B8-B15). Shortly after public disclosure of the market manipulation in August 1966, the American Stock Exchange suspended trading in Westec common stock and Westec went into reorganization under Chapter X of the Bankruptcy Act (A5). Chemetron brought this action in 1967.

On January 14, 1966, while the scheme was in progress, Chemetron exchanged stock and notes of a subsidiary, Pan Geo Atlas Corporation, for 411,866 shares of Westec common stock, which was listed on the American

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1. *See, e. g., United States* v. *Williams*, 447 F. 2d 1285 (5th Cir. 1971), *cert. denied*, 405 U.S. 954 (1972); *United States* v. *Hall*, 457 F.2d 1324 (5th Cir. 1972); *United States* v. *Lilley*, 291 F. Supp. 989 (S.D. Tex. 1968).

Stock Exchange, and 30,000 shares of Westec preferred stock, which was not listed (A4). Westec directors and officers who negotiated with Chemetron on behalf of Westec were engaged in a massive conspiratorial scheme, initiated or joined in by the Respondents, to manipulate the market price of Westec common stock (A3-A6, A47; B3-B7). The conspirary began in September 1964 and continued until August 1966, when Chemetron learned of the scheme, and its notification to the SEC resulted in public disclosure of the scheme and the suspension of trading by the Exchange (A5). One of the purposes of the scheme was to take advantage of Westec's inflated stock prices in acquisition transactions (Tr. 1187, Williams).

After a lengthy trial in 1979, the jury, in response to special interrogatories, found violations in terms of both § 9(a)(2) and Rule 10b-5, as well as Texas law. But it also answered "No" to the question whether the price paid by Chemetron "was affected by [the] plan or scheme to manipulate" (B3). The District Court accordingly granted Chemetron a judgment under Rule 10b-5 and Texas law.[2] Chemetron moved for judgment n. o. v. under § 9(e) on the ground that any price that did not reflect disclosure of the scheme was a "false" price and thus "affected by" the nondisclosure of the illegal scheme as a matter of law. This motion was denied (C1).

A split panel of the Court of Appeals (1) reversed and remanded for a new trial so far as Texas law was concerned, (2) rejected Chemetron's cross-appeal on the

2. The Respondents were held jointly and severally liable for actual damages of $4,726,128 under federal and state law, prejudgment interest of $4,817,276, and exemplary damages under Texas law of $9,452,256, less settlement proceeds of $582,500 (A6). The jurisdiction of the district court was based *inter alia* upon § 27 of the 1934 Act, 15 U.S.C. § 78aa, and principles of pendent jurisdiction.

"affected" point under § 9(e), and (3) reversed the judgment under Rule 10b-5 on the ground that "permitting a Rule 10b-5 remedy here would impermissibly nullify the Section 9 remedy and is unnecessary to ensure the fulfillment of Congress' purposes in enacting the 1934 Act" (A36).

The writ sought by this petition should be limited, of course, to federal law. Moreover, the petition will not refer further to the "affected" point under § 9(e). But we pray that the writ, if granted, go to that point as well as the 10b-5 question, because the panel majority's erroneous reading of § 9(e) exacerbates its erroneous view of the relationship of §§ 9(e) and 10(b) by destroying any private remedy for a gross market manipulation.[3]

On the Rule 10b-5 question, the panel majority reasoned that resort to the Rule was foreclosed by its conclusion that a higher burden of proof was required by elements of the § 9(e) remedy for violation of § 9(a) than by Rule 10b-5. The opinion relied principally on *Huddleston v. Herman & MacLean*, 640 F.2d 534 (5th Cir.), *modified on denial of hearing and of rehearing en banc*, 650 F.2d 815 (5th Cir. 1981), pending in this Court as Nos. 81-680 and 81-1076, which were argued on November 9, 1982.

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3. Suffice it to say here that we shall also argue, if the petition is granted, (a) that *every* price of a manipulated security is manifestly a false price until the manipulation is revealed and the market reacts, and (b) that the panel majority's conclusion that this interpretation of § 9(e) "would obviate its causation requirement" (A74) overlooks the frequent presence of "intervening" or multiple causes, such as the suicide of the corporation's president or a foreign country's nationalization of the corporation's properties or a "very drastic general decline in the stock market." *Feit v. Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544, 586-88 (E.D. N. Y. 1971); *see also Rolf v. Blyth, Eastman Dillon & Co., Inc.*, 570 F. 2d 38, 49 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); *Restatement (Second) of Torts* §548A, Comment b (Tent. Draft No. 11, 1965); ALI Federal Securities Code pp. 60, 62 (1980).

In a vigorous dissent, Judge Williams stated (A93):

> Judge Gee's opinion rules out any liability under federal law for the stock manipulations of James Williams and those who participated in or who are responsible for his activities. The opinion is meticulously reasoned. The difficulty I have with it is that it leads to a result which borders on the absurd. In spite of the reasoning, I cannot conclude that Congress intended any such result.

REASONS FOR GRANTING THE WRIT

1. If the Court affirms *Huddleston* (that is to say, if it decides that a buyer with an express remedy under § 11 may nevertheless resort to Rule 10b-5), that decision may well require a reversal here.

2. *Regardless* of the outcome in *Huddleston*, the majority's decision below, which leaves jury determinations of manipulation of the exchange markets without a private federal remedy, not only raises issues of public importance going to the heart of the federal scheme of investor protection but also conflicts directly with a decision of the Court of Appeals for the Seventh Circuit.

Because of the relationship of the questions presented by the two cases, we respectfully suggest that the Court postpone its ruling on this petition until the *Huddleston* decision is announced, and that it then consider the appropriateness of permitting the parties to file supplementary memoranda in the light of that decision. We shall here assume *arguendo* "the worst scenario" from our point of view—which is to say, a reversal in *Huddleston*—and make our case for a writ of certiorari on that assumption.

First: Huddleston raises the question whether a *buyer*, for whom Congress legislated in great detail in §§ 11 and 12(2) of the 1933 Act, 15 U.S.C. §§ 77k, 77*l*(2), can avoid the conditions and limitations of those express remedies by seeking an implied remedy under § 17(a) of the 1933 Act, 15 U.S.C. § 77q(a), and Rule 10b-5. That case thus presents the classic conflict between express and implied *remedies*. For § 11 makes nothing *unlawful*; it simply provides a remedy for misstatements and certain omissions in registration statements under the 1933 Act.

By contrast, the present case involves *two distinct violations*—of § 9(a) and § 10(b), with its reference to "any manipulative . . . device or contrivance." *See Affiliated Ute Citizens* v. *United States*, 406 U. S. 128 (1971), a 10b-5 case that "arose from a stock rigging scheme," as the court put it in *Schaefer* v. *First National Bank of Lincolnwood*, 509 F. 2d 1287, 1292 (7th Cir. 1975), *cert. denied*, 425 U. S. 943 (1976).

The present case, in short, is much more like *United States* v. *Naftalin*, 441 U. S. 768, 778 (1979), where the Court, in holding that § 17(a) applied to "ordinary market trading" (as distinct from an initial distribution of securities) despite Rule 10b-5, stated that "some overlap is neither unusual nor unfortunate." The Court there quoted from *SEC* v. *National Securities, Inc.*, 393 U. S. 453, 468 (1969), where it had applied Rule 10b-5 to a merger of two insurance companies notwithstanding the inapplicability of the proxy rules under § 14, 15 U. S. C. § 78n, because the companies did not then have any securities registered under the 1934 Act. Again, in *Edwards* v. *United States*, 312 U. S. 473, 483-84 (1941), the Court held that § 17(a) of the 1933 Act did not *pro tanto* repeal the mail fraud statute; that is to say, if a defendant

were to be convicted under both statutes and the appellate court were to conclude that there was no "security" as a matter of law, that would not lead to a reversal of the mail fraud conviction.

All this is to say that the Respondents were found to have violated two substantive provisions, §§ 9(a) and 10(b), each with its own public and private remedies. If there can be two criminal prosecutions (as there were in this matter)[4] or two SEC-initiated injunctive actions, each considered apart from the other, the conclusion is impelled that there should be two private actions.

Second: It follows that, even if it be assumed *arguendo* that the Petitioner was correctly denied judgment under § 9(e) because of its failure to establish a purchase "at a price which was affected by" the § 9(a)(2) violation, that conclusion no more precludes a recovery under Rule 10b-5 than the non-registration of the insurance company stocks in *National Securities* precluded application of Rule 10b-5 to the merger in that case.

Third: The only other appellate decision on the precise point here involved is in direct conflict. In *Schaefer* v. *First National Bank of Lincolnwood, supra* at 1293, the Court of Appeals for the Seventh Circuit held that "the plaintiffs may make their claim for relief under Rule 10b-5, even though the alleged market rigging scheme also falls squarely within section 9(a)(2)."

Fourth: To be sure, there are anomalies whichever way the present case is decided. On the one hand, one could argue that the "specific" of § 9(e) governs the "general" of Rule 10b-5. But consider the far worse anomaly that would result from a holding that Rule 10b-5

4. In the criminal actions against Westec conspirators indictments were issued and convictions obtained for violations of and conspiracy to violate § 9(a)(1) and (2) *and* Rule 10b-5. *See* cases cited *supra* note 1.

applies only when § 9(e) does not: Section 9 is limited to manipulation of securities registered on an exchange. But Congress did not so limit § 10(b), which prohibits manipulative or deceptive conduct with regard to "... any security registered on a national securities exchange *or* any security not so registered..." (italics supplied). The Commission early employed Rule 10b-5 in its struggle against manipulation of the over-the-counter markets, whether on the theory that manipulation is *per se* a fraudulent or deceptive practice within Clauses (1) and (3) or on the theory that failure to disclose the manipulation is an omission that falls within Clause (2). *See* 3 Loss, *Securities Regulation* 1563-68 (2d ed. 1961), and authorities there cited. But surely it would be odd if there were to be *greater* civil liability for over-the-counter manipulation in violation of Rule 10b-5 than for manipulation of the exchange markets in violation of some portion of § 9(a). It was the great manipulative pools on the stock exchanges in the twenties and early thirties that led as much as anything else to the 1934 Act, whose very title is the Securities *Exchange* Act. *See* § 2(3) of the 1934 Act; S. Rep. No. 792 at 7-11 and H. R. Rep. No. 1383 at 10-11, 73d Cong., 2d Sess. (1934).

Fifth: Remedies for violations of federal securities laws would be synchronized by The American Law Institute's Federal Securities Code (1980). *See* Part XVI ("Fraud, Misrepresentation, and Manipulation"); *Crowell* v. *Pittsburgh & Lake Erie R.R.*, 373 F. Supp. 1303, 1310 (E.D. Pa. 1974). The political process, however, is notoriously slow with respect to major legislation of this sort. Meanwhile the Nation's free securities markets must continue to function, and it is vital that there be no weakening of the established remedies directed against the task, at best difficult, of curbing market manipulation.

Sixth: Defendants' counsel in recent 10b-5 cases routinely trumpet the Court's judgments in *Blue Chip*[5] (that the plaintiff must be a buyer or seller) and *Hochfelder*[6] (that scienter is required) and *Sante Fe*[7] (that corporate mismanagement is not a manipulative or deceptive device *per se*) and *Chiarella*[8] (that a duty to disclose does not arise from the mere possession of nonpublic market information); and they expect the walls of Rule 10b-5 to come tumbling down. This, we suggest with respect, is a simplistic view, which ignores the pendulum effect that from time to time becomes apparent in many developing areas of jurisprudence—an effect that goes far to explain "the 10b-5 phenomenon."

The common law view required directors to observe fiduciary standards in dealing with their corporation—the *persona ficta*, the "ghost"—but not in dealing with the flesh-and-blood stockholders that put them into office. That view was hard to swallow in a modern capitalist economy. *See* 3 Loss, *supra*, at 1446-48, and authorities cited therein. The lower federal courts accordingly began using Rule 10b-5 to erect a fiduciary duty to stockholders as a matter of federal law. But they overreacted, to a point where some decisions permitted persons to sue on the ground that they had been defrauded into *refraining* from buying or selling[9] or permitted recovery on the basis of misstatements that were merely negligent[10] or

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5. *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975).
6. *Ernst & Ernst* v *Hochfelder*, 425 U. S. 185 (1976).
7. *Santa Fe Industries, Inc.* v. *Green*, 430 U. S. 462 (1977).
8. *Chiarella* v. *United States*, 445 U. S. 222 (1980).
9. *Stockwell* v. *Reynolds & Co.*, 252 F. Supp. 215 (S. D. N. Y. 1965).
10. *Ellis* v. *Carter*, 291 F. 2d 270 (9th Cir. 1961).

on a "new fraud theory," as some called it, that equated domination *cum* unfair pricing with "fraud."[11]

Ultimately this Court, as might have been expected, reduced the pendulum's arc. But it has also been careful not to overreact to the lower courts' overreaction by barring private actions under Rule 10b-5 altogether. *Cannon* v. *University of Chicago*, 441 U. S. 677, 692 n. 13 (1979); *Touche Ross & Co.* v. *Redington*, 442 U. S. 560, 577 n. 19 (1979). There would be little left of this 10b-5 preservation if, because of a failure to establish one of the elements of a remedy for violation of another substantive provision, the Court's saving language were not to extend to conduct so profoundly destructive of our entire economic system as the laying of hands on the market's scales of supply and demand.

Seventh: It is highly significant in this connection that we are dealing here not with simple fraud but with *manipulation*—a "term of art," in Justice Powell's language, that "connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities." *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 199 (1976); *see also* White, J., in *Santa Fe Industries, Inc.* v. *Green*, 430 U. S. 462, 476 (1977). This is what has been not merely alleged but *proved* in this case. Moreover, whereas every extension of Rule 10b-5 in a simple *fraud* case can be viewed as displacing a highly refined body of state law, the attack on *manipulation* has been almost entirely federal; there simply is no common law to speak of in this country that

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11. *Schoenbaum* v. *Firstbrook*, 405 F. 2d 215 (2d Cir. 1968) (*en banc*), *cert. denied sub nom. Manley* v. *Schoenbaum*, 395 U. S. 906 (1969); *see* Note, *The Controlling Influence Standard in Rule 10b-5 Corporate Mismanagement Cases*, 86 Harv. L. Rev. 1007 (1973).

provides redress to investors against manipulators.[12] The *Restatement (Second) of Torts* has two chapters on "misrepresentation" (including "nondisclosure")[13] but not a word on market manipulation.

In this state of affairs, we respectfully suggest, there is neither need nor justification for the sort of "constricted 'color matching' approach,"[14] indulged in by the panel majority, that overlooks the resulting picture—a picture of grievous harm to the prime legislative objective of cleansing the Nation's securities markets of manipulative influences.

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12. The story is told, with citations to early English as well as the few American cases, in 3 Loss, *Securities Regulation* 1531-40 (2d ed. 1961).

13. *Restatement (Second) of Torts*, cc. 22, 23.

14. The phrase is Justice Harlan's in his dissenting opinion in *SEC* v. *Variable Annuity Life Insurance Co. of America*, 359 U.S. 65, 96 (1959).

CONCLUSION

A writ of certiorari should issue to the Court of Appeals for the Fifth Circuit.

Respectfully submitted,

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